STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
PROPERTY TAXES DEPARTMENT
450 N STREET, MIC: 63, SACRAMENTO, CALIFORNIA
(PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0063)
TELEPHONE (916) 445-1516
FAX (916) 323-8765

JOHAN KLEHS
First District, Hayward

DEAN F. ANDAL
Second District, Stockton

CLAUDE PARRISH
Third District, Torrance

JOHN CHIANG
Fourth District, Los Angeles

KATHLEEN CONNELL
Controller, Sacramento

E. L. SORENSEN, JR.
Executive Director

October 22, 1999

No. 99/56

TO COUNTY ASSESSORS:

CORRECTION TO ASSESSORS' HANDBOOK SECTION 504, *ASSESSMENT OF PERSONAL PROPERTY AND FIXTURES*

On July 1, 1999 the Board approved an amendment to the new AH 504, *Assessment of Personal Property and Fixtures,* to correct an error discovered in the last paragraph on page 66 which could have been misleading to readers. The wording change is as follows:

> The appraiser should recognize that depreciation from reproduction cost new is different from depreciation from ~~reproduction~~ replacement cost new when these costs are different.

The error has been corrected and replacement pages are attached (pages 66-67). The complete document posted on the Board's Web site at www.boe.ca.gov has also been updated. The content of these pages and the remainder of the handbook section has otherwise remained unchanged.

If you have any questions, please contact Ladeena Ford or Mara Determan at (916) 324-5839.

Sincerely,

/s/ Richard C. Johnson

Richard C. Johnson
Deputy Director
Property Taxes Department

RCJ:lf/md

Trade level is an important concept in the assessment valuation process. The Business Property Statement requires that assessees report costs at the proper trade-level.[122] During the course of an audit the auditor-appraiser should verify that the assessee compiled and reported at the proper trade level, and that all necessary and appropriate adjustments have been made.

Depreciation of Machinery & Equipment

Depreciation, for appraisal purposes, is a loss in value from any cause. It is the difference between the value of a hypothetical new, similar property and the current value of the subject property; the total measure of the reduced value at a particular point in time. In other words, it is a by-product of the value estimate.

For appraisal purposes, depreciation occurs in two different ways. First, and probably most important, the remaining economic life of a property may decline. Instead of yielding benefits for ten years as when new, a property may now have only eight years remaining service. Second, there may be a reduction in net benefits from the property. Fewer benefits may be provided, or the same benefits are provided at a higher cost (thus, fewer net benefits are provided). Thus, a decline in the remaining life or the efficiency of property causes depreciation.

The appraiser's definition and use of depreciation is fundamentally different from the accountant's definition and use of depreciation, as discussed earlier regarding value. The accountant uses depreciation to amortize a property's cost over the life of the property. Each year the accountant estimates depreciation, based on a preselected life, to recover the cost of the equipment in the most beneficial legal manner for GAAP and/or income tax purposes.

These definitional differences are represented mathematically below:

Replacement Cost New - Depreciation = Current Market Value (Appraiser)

Reproduction Cost New - Depreciation = Current Market Value (Appraiser)

Capitalized Cost - Depreciation = Book Value (Accountant)

The appraiser should recognize that depreciation from reproduction cost new is different from depreciation from replacement cost new when these costs are different. The appraiser cannot use the accountant's depreciation estimate when valuing an asset because he or she must determine an estimate of depreciation which directly relates to the actual loss in value the property has incurred. Accountants are not concerned with representing market value at any point in time, but are concerned only with writing off the cost incurred to purchase the asset. If book value (capitalized cost - depreciation = book value) has any relation to market value, it is only coincidental. Rather than using depreciation computed for accounting purposes as an estimate, appraisers should use methods of estimating depreciation that represent the loss in value a property has suffered.

[122] Rule 10.

Although depreciation may be, and most often is, estimated in a lump sum, it is important to be aware of each type of depreciation in order to determine (1) if all necessary adjustments have been made and (2) that there are no duplicate allowances for any one type. Each type of depreciation: physical deterioration, functional obsolescence, and external obsolescence, is defined and discussed below.

Types of Depreciation Defined

A property may suffer from one or more forms of depreciation. That is, a single piece of equipment may contain elements of physical deterioration as well as both functional and external obsolescence. In some cases, calculation methodologies may be used to separately estimate the amount of depreciation attributable to each cause. In many situations, however, it may be impossible to categorize the amount of depreciation attributable to each cause. Regardless of whether total depreciation is calculated as a whole or as a sum of parts, recognizing and identifying the types of depreciation applicable to a property may aid in estimating total depreciation to arrive at value.

Physical Deterioration

Physical deterioration is the loss in value which may be the result of wear and tear either from use or exposure to various elements. This type of depreciation is expected on most equipment. Virtually all properties deteriorate as they age, and it is not abnormal unless equipment is put to excessive use or misused. Good maintenance will slow the process, while lack of maintenance and overuse will increase physical deterioration.

Most physical deterioration can be corrected. However, the relationship between the costs involved and the economic benefit derived determines whether it is economically feasible to correct or repair physical deterioration. An element of physical deterioration is considered *curable* when the cost to correct the deficiency is less than the economic benefit resulting therefrom. When the cost to correct the deficiency is greater than the resulting economic benefit, the element of physical deterioration is considered *incurable*.

Functional Obsolescence

Functional obsolescence is the loss of value in a property caused by the design of the property itself. When the capacity of a property to perform the function for which it was intended declines, functional obsolescence is present. Functional obsolescence may include such things as: changes in taste in the marketplace; changes in equipment design, materials, or process; or poor initial design.

Changing technology commonly creates functional obsolescence for machinery and equipment, and some functional obsolescence can be or should be considered normal to varying degrees (depending upon the industry and equipment type). Older machines and sometimes newer machines or entire lines of equipment, even though still in use, may be made obsolete by new technologies and manufacturing processes and the market value may be reduced because of functional obsolescence.